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Expenditure Practices of Provincial and Local Governments: The Case of Nepal

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Abstract

Nepal promulgated a new constitution in 2015, which adopted a federal system of governance to achieve economic equality, prosperity and social justice. The constitution has allocated expenditure responsibilities to each level of government. In such a scenario, this study employs a descriptive approach to analyze the spending practices of Nepal's provincial and local governments. Secondary sources of data were used to cover the period from 2018/19 to 2021/22. The study found that the average share of recurrent expenditure at the provincial level of Nepal was 42.5% while such share of capital expenditure was 57.5%. At the local level, the average share of recurrent and capital expenditure was 60.5% and 39.5% respectively. Within the capital expenditure of Nepal's provincial governments, the average share of expenditure items having relatively more contribution to capital formation was 70.6% while that of local governments, such share was 52.9% only. The study also found that Nepal's provincial and local governments spend less on the major subnational service delivery areas. Nepal's subnational government spending practices highlight the need to spend more on capital formation. Within the capital formation, more spending on the areas having a direct impact on their future growth and prosperity is necessary. The subnational governments must also spend more on major subnational service delivery areas.

Keywords: Decentralization, fiscal federalism, local government expenditure, Nepal, provincial government expenditure, subnational governments, subnational service delivery

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Introduction

Over the years, the expenditure responsibilities of subnational governments have changed as a result of decentralization (Organization for Economic Co-operation and Development [OECD, 2016]). Decentralization has shifted numerous responsibilities from the national government to subnational governments. The underlying proposition is that governments which are closest to the people can allocate resources to address their preferences. Thus, decentralization is expected to improve service delivery by addressing the specific needs of residents. As a consequence, the significance of subnational governments has been heightened through the process of decentralization. According to Ebel and Yilmaz (2002), subnational governments function as service providers as they deliver services to specific recipients. They continue to provide these services until the cost of the last unit of service matches the benefit received by the recipients.

Expenditure decentralization aims to improve service delivery. The findings of the studies indicate that its impact on the efficiency of public service delivery is mixed (Kahkonen & Lanyi, 2001). To enhance the delivery of public services, it is crucial to establish a favorable institutional framework that includes autonomous local governments, robust accountability mechanisms at different levels of institutions, good governance practices and strengthened capacity at the local level (Sow & Razafimahefa, 2015).

The Constitution of Nepal (2015) recognizes federalism as one of the key mechanisms for attaining economic equality, prosperity and social justice. Since the advent of federalism in Nepal, the responsibilities of the subnational governments have increased significantly. Both the provincial and the local governments have been given expenditure responsibilities. The power of the provinces is defined in Schedule 6 whereas the concurrent power of the federal government and the provinces is defined in Schedule 7. The local levels' power is defined in Schedule 8 and the concurrent power of the federal, provincial and local governments are defined in Schedule 9. To meet the responsibilities assigned to the provinces and local levels, they must increase their expenditure accordingly. In practice, the expenditures of the subnational government in Nepal have increased significantly in recent years.

Subnational economies play a crucial role in Nepal's national economy. The way they spend their resources has a direct impact on the overall functioning of the country's economy, including economic growth, employment opportunities and the income of its people. Therefore, the stability of Nepal's economy is partially dependent on the spending practices of its subnational governments. It is essential to understand how these governments allocate their resources to identify any necessary corrective measures that may need to be taken. The objective of this study is to analyze the spending practices of provincial and local governments of Nepal. More specifically, the study aims to examine the composition of their expenditure and identify the key areas where these governments allocate their funds. It is important to note that this study has certain limitations related to data due to Nepal's limited experience in implementing federalism and the associated fiscal federalism. Data for this study is only available for a few fiscal years. However, despite this limitation, the findings of this study hold significant implications for both academia and policymakers.

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This paper is divided into five sections. The initial section serves as an introduction to the study, outlining its objectives and highlighting its significance. Following this, the second section provides a comprehensive review of the relevant literature. The third section then proceeds to describe the methodology employed in the study. Moving forward, the fourth section presents the results of the study and engages in a thorough discussion of these results. Lastly, the fifth section offers a conclusive summary of the study.

Literature Review

De Xavier et al. (2021) examined the effects of decentralization on India's subnational economic growth. The study was carried out using a fixed effect panel data model for a period from 1981/82 to 2015/16. Data were collected from 14 Indian states. Economic growth was measured by using gross state domestic product per capita as a proxy variable. Decentralization was measured in terms of expenditure and revenue decentralization. Share of capital expenditure to total state expenditure, share of social expenditure to total state expenditure and liberalization were used as control variables. The study unveiled a positive relationship between expenditure decentralization, revenue decentralization, the share of capital expenditure to total state expenditure, the share of social expenditure to total state expenditure and liberalization, and economic growth. Expenditure decentralization demonstrated a non-linear relationship with economic growth whereas revenue decentralization exhibited a linear relationship. Hence, the research demonstrates that enhancing the efficiency of resource allocation across various tiers of government in India can contribute to the increase in economic growth of Indian states. Thus, devolution of expenditure and revenue responsibilities to the states was found to be desirable in India.

Florian et al. (2020) analyzed the determinants of social expenditure in 31 OECD countries by applying extreme bounds analysis. Social expenditure was the dependent variable. The old age dependency ratio and the unemployment rate were the standard explanatory variables. Various economic and demographic variables, globalization-welfare indexes, political-institutional variables, and political-economic variables were also taken as explanatory variables. The study found that budget deficit, trade globalization and fractionalization of the party system had a negative impact while aging, unemployment, social globalization and public debt had a positive impact on social expenditure. During periods of significant de facto trade globalization, social expenditure experienced a rise under left-wing governments. Authors conclude that a significant portion of the budget allocated to social affairs often appears predetermined and externally influenced by factors beyond policymakers' control. Globalization, demographic shifts and economic downturns exert automatic effects on social expenditure, leaving domestic policymakers with limited options for designing spending on social affairs.

Mohanty and Bhanumurthy (2020) analyzed the efficiency of state government expenditure on the social sector in India. The study was based on data from 27 Indian states. Data envelopment analysis was employed in order to analyze the data of three different years 2002/03, 2008/09 and 2015/16. The study indicates a significant diversity in the effectiveness of public expenditure at the state level in India, suggesting the potential for resource conservation. The study reveals that states exhibit higher efficiency in allocating

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resources to education compared to health and overall social sector spending. Additionally, authors identify factors such as quality of governance, economic growth and mothers' schooling as influencing the efficiency of education, health, and social sector, with governance having a more substantial impact than other variables. Finally, the study concludes that enhancing governance could lead to improved outcomes from public expenditure.

Kuntari et al. (2019) analyzed the factors affecting the capital expenditure of local governments of Indonesia. The study was based on 35 local governments of Central Java province. Secondary data for the period 2014/15-2016/17 were analyzed by using regression analysis. Capital expenditure was the dependent variable which was measured in terms of expenditure on the purchase of land; purchase of equipment and machinery; purchase of buildings; development of roads, irrigation, networking; and other fixed assets. The independent variables were locally generated revenue, general allocation fund, special allocation fund and revenue sharing fund. The study found that all of the independent variables considered had a significantly positive impact on capital expenditure. The authors conclude that local governments should continue to explore their own-source of revenue so that their dependence on the central government can be reduced and the welfare of their citizens can be improved.

Bojanic (2018) analyzed the impact of fiscal decentralization on accountability, economic freedom, and political and civil liberties in 12 countries in the Americas. The study was conducted by applying panel data analysis. Measures of economic freedom, accountability, and political and civil liberties were regressed against indicators of fiscal decentralization based on revenue and expenditure. The results suggest that at first, decentralization impedes accountability and political and civil liberties, but over time, it enhances them, aligning with the anticipated positive connection between increased fiscal autonomy and a more inclusive, participatory government. However, the influence of fiscal decentralization on economic freedom contradicts the expectations. Initially, decentralization appears to support freedom, but ultimately restricts it, demonstrating that improved accountability and political and civil liberties do not necessarily result in greater economic freedom. The key takeaway from this research is that fiscal decentralization has the potential to act as a catalyst for increased accountability, political participation and civil liberty. However, when considering developing American nations, decentralization must be coupled with various additional measures, like enhancing the quality and effectiveness of government, managing government debt and promoting a stronger adherence to the rule of law.

Drew et al. (2014) analyzed whether economies of scale occur in local government expenditure in Australia. The study was based on the data of 2009/10 of 152 local governments of New South Wales. Per capita expenditure was the dependent variable while population, population squared, population density, population growth, percentage of the population identifying as Aboriginal and Torres Strait Islanders, hectares of agricultural land, etc. were the independent variables. The relationship between independent and dependent variables was analyzed by using the ordinary least-squared model. Initially, study found that local government expenditure was characterized by economies of scale.

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However, while dividing 152 local governments into four groups, the evidence for economies of scale was found to be disappeared for local governments with low population densities. Linear regression analysis suggested that there may be diseconomies of scale while non-linear regression analysis suggested that there is little evidence for economies of scale for metropolitan councils. Thus, the study found limited evidence of economies of scale in the expenditure of local governments of New South Wales.

Jia et al. (2014) analyzed the impact of fiscal decentralization on local spending policies in China by applying dynamic panel data analysis. Additionally, the authors investigated how vertical fiscal imbalance affects these policies. Data were taken from 1920 counties for the period 1997/98-2006/07. Local expenditure policy was the dependent variable while expenditure decentralization, revenue decentralization, real GDP per capita, population density, own-source revenue size, etc. were the explanatory variables. The findings of the study indicate that expenditure decentralization results in increased government spending, leading to a distribution of funds with a higher emphasis on capital formation and reduced allocations for education and administration. Conversely, revenue decentralization has less influence on local government expenditure. Authors argue that the variations in the effects of expenditure and revenue decentralization can be traced back to the distortions caused by the vertical fiscal imbalance. The result of this study shows the existence of a common pool problem within China's fiscal system at the county level. Finally, the authors conclude that an unbalanced fiscal structure between expenditure and revenue at the local level encourages opportunistic overspending by local governments in China. To address this tendency, a practical reform for the existing fiscal system would involve empowering local governments with greater authority over revenue collection or reducing their expenditure burden. Implementation of this proposed fiscal framework would establish a more harmonized distribution of fiscal responsibilities for local governments, strengthening their accountability in managing expenditures.

Painter and Bae (2001) analyzed the determinants of state expenditure in the United States. Study was conducted by applying panel data analysis on the data of the period 1965/66-1992/93. State expenditure per capita was the dependent variable while independent variables included the various demographic, institutional and political variables. The study found that demographic factors have a significant impact on state government expenditure. Per capita income, total long-term debt and the unemployment rate were found to have a positive impact on state government expenditure. The influence of the number of children in primary or secondary school on the expenditures was found to be less important while number of prisoners and college-age students emerged as a notable positive factor influencing expenditure. Institutional factors, like state-level constraints on taxes and expenditures were found to reduce overall expenditure. Regarding the political factors affecting state expenditure, authors argue that it is crucial to incorporate state-specific effects into the model to assess the significance of inter-party competition on spending. States with a more balanced legislature tend to exhibit lower spending. It was found that Democratic administrations tend to spend more than Republican administration, and higher spending was found to be linked to an increased number of government workers per capita. Notably, governments controlled by a single party tend to exhibit increased spending. The

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authors conclude that the effect of such determinants of state expenditure change over time.

Methods

In this study, a descriptive approach has been used. Secondary sources of data covering the period of 2018/19 to 2021/22 have been included in the study. Data have been sourced from various publications of the Financial Comptroller General Office (FCGO), Nepal; Ministry of Finance, Government of Nepal; journal articles; books; etc. The reason behind considering data for the period 2018/19-2021/22 is that data that are relevant for the study are available for this period only. The challenge arises from the limited exposure of Nepal's federalism and the associated fiscal federalism. Furthermore, most of the data used in this study are available for only two fiscal years 2020/21 and 2021/22 as presented in tables 1, 3, 4, 5 and 6.

Results and Discussion

This section analyzes the composition of total and capital expenditure for provincial and local governments, examining their function-wise expenditure as well.

Composition of provincial government expenditure

Table 1 shows the composition of provincial government expenditure in Nepal. Most of the provinces have higher share of capital expenditure (CE). In 2018/19, only Bagmati province had lower share of capital expenditure than recurrent expenditure (RE), other provinces have higher share of capital expenditure. In 2019/20, only Madhesh province had a lower share of capital expenditure. In 2020/21 and 2021/22, all provinces had a higher share of capital expenditure. Thus, provinces are using most of their resources in the capital formation. On average, the share of capital expenditure of all provinces was 57.5%. Although this is the relatively better situation of resource allocation, there is the necessity of further increase in the share of capital expenditure of provinces. For this, there is the necessity of reducing unproductive expenditure related to recurrent expenditure of provinces. The higher share of capital expenditure is desirable because it contributes to the future economic growth and prosperity of provinces, and hence the national economy as a whole.

Table 1

Composition of provincial government expenditure (%)

Provinces	2018/19		2019/20		2020/21		2021/22	
	RE	CE	RE	CE	RE	CE	RE	CE
Koshi	46.1	53.9	40.1	59.9	43.2	56.8	43.8	56.2
Madhesh	43.9	56.1	54.3	45.7	38.3	61.7	46.4	53.6
Bagmati	53.7	46.3	43.9	56.1	43.8	56.2	42.8	57.2
Gandaki	37.4	62.6	31.5	68.5	31.3	68.7	34.4	65.6
Lumbini	40.3	59.7	42.1	57.9	42.4	57.6	42.1	57.9
Karnali	45.9	54.1	43.5	56.5	38.4	61.6	37.6	62.4
Sudurpaschim	48.9	51.1	47.3	52.7	45.1	54.9	42.8	57.2

Source: Author's calculation based on MOF (2022, 2023).

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Composition of local government expenditure

Table 2 shows the composition of local government expenditure in 2020/21 and 2021/22. Such composition of expenditure is computed for all four types of local levels as well as for all local levels in aggregate. In both years, for all types of local levels, recurrent expenditure (RE) has an overwhelming share of total expenditure. Capital expenditure (CE) has lower share compared to recurrent expenditure. Financing expenditure (FE) has a very limited share of total expenditure of local levels.

Table 2

Composition of local government expenditure (%)

Local level	2020/21			2021/22		
	RE	CE	FE	RE	CE	FE
Rural municipality	61.9	38.1	0.0	63.5	36.5	0.0
Municipality	59.0	41.0	0.0	59.7	40.3	0.0
Sub-metropolitan city	56.8	42.8	0.5	54.5	45.1	0.4
Metropolitan city	54.3	45.0	0.7	55.2	44.0	0.9
All local levels	60.0	39.9	0.1	60.9	39.0	0.1

Source: Author's calculation based on FCGO (2022, 2023).

A relatively low share of capital expenditure is a matter of worry for a least-developed country like Nepal. This is because the stock of capital goods, like infrastructure, is significantly low in Nepal. Among the four types of local levels, the metropolitan city has the highest share of capital expenditure (44.5%) followed by sub-metropolitan city (44%), municipality (40.7%) and rural municipality (37.3%), on average. Among the local levels, the rural municipalities have the lowest stock of capital goods in practice. This scenario suggests that there is a necessity to reduce recurrent expenditure and increase the capital expenditure of local governments. The average share of recurrent expenditure for all types of local levels in aggregate was 60.5% while such share of capital expenditure and financing expenditure was 39.5% and 0.1% respectively.

Composition of capital expenditure of provincial and local governments

Analysis of the composition of capital expenditure of provincial and local governments is of vital importance. This is because all forms of capital expenditure are not equally important for the growth and prosperity of the country. For example, spending on vehicles for government officials; furniture; structural improvement of constructed buildings; land acquisition; goods; contract, lease and license purchase expenses; etc. have relatively less contribution to the future growth and prosperity of the country. These are also a part of capital expenditure. So, if such expenses have a significant share of capital expenditure, such kind of resource allocation is less effective for the development of the respective local levels and provinces.

Table 3 shows the composition of capital expenditure of provinces of Nepal in 2020/21 and

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2021/22. In the table, the first seven types of expenditure have a relatively more direct impact on employment and income generation. They have more effect on direct service delivery and promotion of private sector activities. So, these types of expenditures are more effective for future growth and prosperity. Data suggest that the aggregate spending on the first seven items of table 3 was 74.4% in 2020/21 while 66.8% in 2021/22, i.e. on average it was 70.6%.

Table 3

Composition of capital expenditure of provinces of Nepal (%)

Type of capital expenditure	2020/21	2021/22
Non-residential building purchase/construction	9.3	9.5
Animal asset and horticulture development	0.0	0.0
Road and bridge construction	37.1	31.6
Hydropower infrastructure construction	0.7	0.7
Irrigation infrastructure construction	11.2	10.7
Water supply infrastructure construction	15.5	14.1
Sanitation infrastructure construction	0.6	0.2
Other public construction works	10.7	11.5
Transport vehicles	1.1	1.5
Consultancy/capital research and consultancy	0.9	0.9
Other expenses	12.9	19.3

Source: Author's calculation based on FCGO (2022, 2023).

Table 4 shows the composition of capital expenditure at the local levels of Nepal in 2020/21 and 2021/22. In the table, the sum of the first eight types of expenditure items, which have a relatively more direct impact on service delivery, employment and income, and promotion of private sector activities was 53.3% in 2020/21 while 52.5% in 2021/22, i.e. on average it was 52.9% in the study period. Thus, available data suggest that, in practice, the overall capital expenditure of local levels of Nepal has no significant contribution to their capital formation. Compared to local levels, provinces have desirable practices of spending.

Table 4

Composition of capital expenditure of local levels of Nepal (%)

Type of capital expenditure	2020/21	2021/22
Non-residential building purchase/construction	11.5	11.0
Animal asset and horticulture development	1.0	0.7
Road and bridge construction	31.9	31.5
Railway and airport construction	0.0	0.0
Hydropower infrastructure construction	1.2	1.4
Irrigation infrastructure construction	2.2	2.6
Water supply infrastructure construction	4.8	4.5
Sanitation infrastructure construction	0.7	0.8
Other public construction works	32.9	32.9
Capital consultancy/capital research and consultancy	1.3	1.3
Transport vehicle	0.9	0.6
Other expenses	12.5	12.7

Source: Author's calculation based on FCGO (2022, 2023).

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Function-wise expenditure of provincial governments

Table 5 presents an overview of the expenditure distribution of provincial governments of Nepal based on functions. The data indicates that the majority of resources are being allocated to two functions, namely general public service and economic affairs. It is worth noting that these functions do not fall under major subnational service delivery areas. Disappointingly, both the education and health sectors receive relatively low levels of funding. In the table, K, M, B, G, L, KA and SP represent Koshi, Madhesh, Bagmati, Gandaki, Lumbini, Karnali and Sudurpaschim provinces respectively.

Table 5
Function-wise expenditure of provincial governments (%)

Function	2020/21							2021/22						
	K	M	B	G	L	KA	SP	K	M	B	G	L	KA	SP
General public service	28.8	49.7	53.0	17.0	48.5	34.9	18.3	22.8	19.7	41.2	13.1	27.4	25.0	11.1
Public order and safety	1.2	2.2	2.3	0.1	0.7	1.4	2.1	1.0	2.0	1.5	0.1	0.7	1.2	2.6
Economic affairs	26.3	31.1	30.0	60.8	30.3	33.0	55.6	36.8	45.4	27.8	50.4	38.0	42.1	51.9
Environmental protection	3.1	0.0	2.6	2.0	1.9	0.0	0.0	3.7	0.1	3.1	3.8	2.5	0.1	0.1
Housing and community amenities	33.4	2.9	7.9	11.0	11.2	0.0	6.5	22.5	11.0	14.2	18.4	13.1	3.8	10.7
Health	5.2	8.1	2.8	4.4	2.8	5.8	9.0	9.0	13.6	8.1	8.8	9.2	11.8	13.7
Recreation, culture and religion	1.3	0.0	0.0	0.1	2.0	0.0	0.0	0.5	0.7	0.4	1.3	2.9	0.1	0.1
Education	0.7	1.0	1.3	4.6	2.1	0.7	8.5	3.5	4.1	3.7	4.3	5.9	2.2	9.8
Social protection	0.1	5.0	0.0	0.0	0.6	24.1	0.0	0.1	3.5	0.0	0.0	0.3	13.6	0.0

Source: Author's calculation based on FCGO (2022, 2023).

Function-wise expenditure of local governments

Table 6 presents the distribution of expenditure across various functions carried out by the local governments of Nepal during 2020/21 and 2021/22. The data reveals that education receives the highest allocation of resources, followed by economic affairs, general public service, housing and community amenities, health, social protection, environmental protection, and public order and safety. Among these functions, education, economic affairs, and general public service accounted for 76.5% of the total expenditure in 2020/21 and 75.6% in 2021/22. Consequently, it can be inferred that the local governments of Nepal allocate a substantial proportion of their resources toward a few specific functions. However, their expenditure on major subnational service delivery areas appears to be relatively low.

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Table 6

Function-wise expenditure of local governments (%)

Function	2020/21	2021/22
General public service	22.9	22.5
Public order and safety	0.7	0.2
Economic affairs	23.8	22.6
Environmental protection	1.5	1.4
Housing and community amenities	9.4	9.5
Health	7.2	7.5
Recreation, culture and religion	1.7	2.1
Education	29.8	30.5
Social protection	3.1	3.8

Source: Author's calculation based on FCGO (2022, 2023).

To sum up, both provincial and local governments' spending patterns seem to be the same in the case of Nepal. This is a disappointing scenario because the subnational governments of Nepal are not working properly in those areas where they are assumed to work. There is a necessity to change such a pattern of expenditure policy of the subnational governments of Nepal as they are assumed to be more efficient in subnational matters compared to the federal government.

Conclusion

This study analyzed the spending practices of the provincial and local governments of Nepal. The study adopts a descriptive approach and examines data from the period 2018/19 to 2021/22. It delved into the composition of total and capital expenditure for provincial and local governments, examining their function-wise expenditure as well. The 2015 constitution of Nepal embraces federalism as a means to achieve economic equality, prosperity and social justice. It assigns expenditure responsibilities to provinces and local levels, outlining their powers in schedules 6, 7, 8, and 9. Meeting these responsibilities necessitates increased spending. Notably, there has been a significant increase in subnational government expenditure in Nepal in recent years. Regarding provincial governments, the share of capital expenditure was generally higher than the share of recurrent expenditure. The average share of capital and recurrent expenditure was 57.5% and 42.5%, respectively, in the study period. The study reveals that local governments primarily allocate their resources towards recurrent expenditures. The share of capital expenditure, on average, during the study period was 39.5%, while the share of recurrent expenditure was 60.5% in the case of local governments. The study found that within the capital expenditure of provincial governments, the share of expenditure items that have relatively more contribution to capital formation was 74.4% in 2020/21 and 66.8% in 2021/22 while such share of local governments was 53.3% in 2020/21 and 52.5% in 2021/22. The provincial and local governments of Nepal were found to have less expenditure on major subnational service delivery areas.

The expenditure policy of subnational governments needs to be changed. It is crucial to increase spending on capital formation, particularly in the areas that have a direct impact on

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future growth and prosperity. They need to increase spending on major subnational service delivery areas as they are assumed to be more efficient in subnational matters compared to the federal government. As the subnational economies play a significant role in the national economy of Nepal, their spending practices have implications for the country's future growth and prosperity. Therefore, a comprehensive reform of their spending practices is necessary in this context.

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